

(iii) *Apportionment.* No apportionment is necessary since the entire expense is allocated to the residual grouping, gross income from sales within the United States.

Example 6. (i) *Facts.* X, a domestic corporation, is engaged in continuous research and experimentation to improve the quality of the products that it manufactures and sells, which are floodlights, flashlights, fuse boxes, and solderless connectors. X incurs and deducts \$100,000 of expenditure for research and experimentation in 1997 that was performed exclusively in the United States. As a result of this research activity, X acquires patents that it uses in its own manufacturing activity. X licenses its floodlight patent to Y and Z, uncontrolled foreign corporations, for use in their own territories, countries Y and Z, respectively. Corporation Y pays X an arm's length royalty of \$3,000 plus \$0.20 for each floodlight sold. Sales of floodlights by Y for the taxable year are \$135,000 (at \$4.50 per unit) or 30,000 units, and the royalty is \$9,000 ($\$3,000 + \$0.20 \times 30,000$). Y has sales of other products of \$500,000. Z pays X an arm's length royalty of \$3,000 plus \$0.30 for each unit sold. Z manufactures 30,000 floodlights in the taxable year, and the royalty is \$12,000 ($\$3,000 + \$0.30 \times 30,000$). The dollar value of Z's floodlight sales is not known and cannot be reasonably estimated because, in this case, the floodlights are not sold separately by Z but are instead used as a component in Z's manufacture of lighting equipment for theaters. The sales of all Z's products, including the lighting equipment for theaters, are \$1,000,000. Y and Z each sell the floodlights exclusively within their respective countries. X's sales of floodlights for the taxable year are \$500,000 and its sales of its other products, flashlights, fuse boxes, and solderless connectors, are \$400,000. X has gross income of \$500,000, consisting of gross income from domestic sources from sales of floodlights, flashlights, fuse boxes, and solderless connectors of \$479,000, and royalty income of \$9,000 and \$12,000 from foreign corporations Y and Z respectively. X utilized the optional gross income methods of apportionment for its return filed for its first taxable year to which this section applies.

(ii) *Allocation.* X's research and experimental expenses are definitely related to all of the products that it produces, which are floodlights, flashlights, fuse boxes, and solderless connectors. All of these products are in the same three digit SIC Code category, Electric Lighting and Wiring Equipment (SIC Industry Group 364). Thus, X's research and experimental expenses are allocable to all items of income attributable to this product category, domestic sales income and royalty income from the foreign countries in which corporations Y and Z operate.

(iii) *Apportionment.* (A) The statutory grouping of gross income is general limitation income from sources without the United

States. The residual grouping is gross income from sources within the United States. X's deduction of \$100,000 for its research expenditures must be apportioned between the groupings. For apportionment on the basis of sales in accordance with paragraph (c) of this section, X is entitled to an exclusive apportionment of 50 percent of its research and experimental expense to the residual grouping, gross income from sources within the United States, since more than 50 percent of the research activity was performed in the United States. The remaining 50 percent of the deduction can then be apportioned between the residual and statutory groupings on the basis of sales. Since Y and Z are unrelated licensees of X, only their sales of the licensed product, floodlights, are included for purposes of apportionment. Floodlight sales of Z are unknown, but are estimated at ten times royalties from Z, or \$120,000. All of X's sales from the entire product category are included for purposes of apportionment on the basis of sales. Alternatively, X may apportion its deduction on the basis of gross income, in accordance with paragraph (d) of this section. The apportionment is as follows:

(1) *Tentative Apportionment on the Basis of Sales*

(i) Research and experimental expense to be apportioned between statutory and residual groupings of gross income:	\$100,000
(ii) Less: Exclusive apportionment of research and experimental expense to the residual groupings of gross income ($\$100,000 \times 50$ percent):	\$50,000
(iii) Research and experimental expense to be apportioned between the statutory and residual groupings of gross income on the basis of sales:	\$50,000
(iv) Apportionment of research and experimental expense to the residual groupings of gross income ($\$50,000 \times \$900,000/(\$900,000 + \$135,000 + \$120,000)$):	\$38,961
(v) Apportionment of research and experimental expense to the statutory grouping, royalty income from countries Y and Z ($\$50,000 \times \$135,000 + \$120,000/(\$900,000 + \$135,000 + \$120,000)$):	\$11,039
(vi) Total apportioned deduction for research and experimentation:	\$100,000
(vii) Amount apportioned to the residual grouping ($\$50,000 + \$38,961$):	\$88,961
(viii) Amount apportioned to the statutory grouping of sources within countries Y and Z:	\$11,039

(2) *Tentative Apportionment on Gross Income Basis*

(i) Exclusive apportionment of research and experimental expense to the residual grouping of gross income ($\$100,000 \times 25$ percent):	\$25,000
(ii) Apportionment of research and experimental expense to the residual grouping of gross income ($\$75,000 \times \$479,000/\$500,000$):	\$71,850
(iii) Apportionment of research and experimental expense to the statutory grouping of gross income ($\$75,000 \times \$9,000 + \$12,000/\$500,000$):	\$3,150
(iv) Amount apportioned to the residual grouping:	\$96,850

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(v) Amount apportioned to the statutory grouping of general limitation income from sources without the United States: \$3,150

(B) Since X has elected to use the optional gross income methods of apportionment and its apportionment on the basis of gross income to the statutory grouping, \$3,150, is less than 50 percent of its apportionment on the basis of sales to the statutory grouping, \$11,039, it must use Option two of paragraph (d)(3) of this section and apportion \$5,520 (50 percent of \$11,039) to the statutory grouping.

(i) *Applicability date.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

[T.D. 8646, 60 FR 66503, Dec. 22, 1995, as amended by T.D. 9441, 74 FR 390, Jan. 5, 2009; T.D. 9568, 76 FR 80136, Dec. 22, 2011; T.D. 9882, 84 FR 69074, Dec. 17, 2019]

§ 1.861-18 Classification of transactions involving computer programs.

(a) *General*—(1) *Scope.* This section provides rules for classifying transactions relating to computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, sections 367, 404A, 482, 551, 679, 1059A, chapter 3, chapter 5, sections 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by section 679.

(2) *Categories of transactions.* This section generally requires that such transactions be treated as being solely within one of four categories (described in paragraph (b)(1) of this section) and provides certain rules for categorizing such transactions. In the case of a transfer of a copyright right, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a license generating royalty income. In the case of a transfer of a copyrighted article, this section provides rules for determining whether the transaction should be classified as either a sale or exchange, or a lease generating rental income.

(3) *Computer program.* For purposes of this section, a computer program is a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result. For purposes of this paragraph (a)(3), a computer program includes any media, user manuals, documenta-

tion, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.

(b) *Categories of transactions*—(1) *General.* Except as provided in paragraph (b)(2) of this section, a transaction involving the transfer of a computer program, or the provision of services or of know-how with respect to a computer program (collectively, a transfer of a computer program) is treated as being solely one of the following—

(i) A transfer of a copyright right in the computer program;

(ii) A transfer of a copy of the computer program (a copyrighted article);

(iii) The provision of services for the development or modification of the computer program; or

(iv) The provision of know-how relating to computer programming techniques.

(2) *Transactions consisting of more than one category.* Any transaction involving computer programs which consists of more than one of the transactions described in paragraph (b)(1) of this section shall be treated as separate transactions, with the appropriate provisions of this section being applied to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but as part of another transaction.

(c) *Transfers involving copyright rights and copyrighted articles*—(1) *Classification*—(i) *Transfers treated as transfers of copyright rights.* A transfer of a computer program is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described in paragraphs (c)(2)(i) through (iv) of this section. Whether the transaction is treated as being solely the transfer of a copyright right or is treated as separate transactions is determined pursuant to paragraph (b)(1) and (b)(2) of this section. For example, if a person receives a disk containing a copy of a computer program which enables it to exercise, in relation to that program, a

non-de minimis right described in paragraphs (c)(2)(i) through (iv) of this section (and the transaction does not involve, or involves only a de minimis provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section), then, under paragraph (b)(2) of this section, the transfer is classified solely as a transfer of a copyright right.

(ii) *Transfers treated solely as transfers of copyrighted articles.* If a person acquires a copy of a computer program but does not acquire any of the rights described in paragraphs (c)(2)(i) through (iv) of this section (or only acquires a de minimis grant of such rights), and the transaction does not involve, or involves only a de minimis, provision of services as described in paragraph (d) of this section or of know-how as described in paragraph (e) of this section, the transfer of the copy of the computer program is classified solely as a transfer of a copyrighted article.

(2) *Copyright rights.* The copyright rights referred to in paragraph (c)(1) of this section are as follows—

(i) The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

(ii) The right to prepare derivative computer programs based upon the copyrighted computer program;

(iii) The right to make a public performance of the computer program; or

(iv) The right to publicly display the computer program.

(3) *Copyrighted article.* A copyrighted article includes a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium.

(d) *Provision of services.* The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described in paragraph (b)(1) of this section is based on all the

facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

(e) *Provision of know-how.* The provision of information with respect to a computer program will be treated as the provision of know-how for purposes of this section only if the information is—

(1) Information relating to computer programming techniques;

(2) Furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and

(3) Considered property subject to trade secret protection.

(f) *Further classification of transfers involving copyright rights and copyrighted articles—*(1) *Transfers of copyright rights.*

The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income. For this purpose, the principles of sections 1222 and 1235 may be applied. Income derived from the sale or exchange of a copyright right will be sourced under section 865(a), (c), (d), (e), or (h), as appropriate. Income derived from the licensing of a copyright right will be sourced under section 861(a)(4) or 862(a)(4), as appropriate.

(2) *Transfers of copyrighted articles.* The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article

have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income. Income from transactions that are classified as sales or exchanges of copyrighted articles will be sourced under sections 861(a)(6), 862(a)(6), 863, 865(a), (b), (c), or (e), as appropriate. Income derived from the leasing of a copyrighted article will be sourced under section 861(a)(4) or section 862(a)(4), as appropriate.

(3) *Special circumstances of computer programs.* In connection with determinations under this paragraph (f), consideration must be given as appropriate to the special characteristics of computer programs in transactions that take advantage of these characteristics (such as the ability to make perfect copies at minimal cost). For example, a transaction in which a person acquires a copy of a computer program on disk subject to a requirement that the disk be destroyed after a specified period is generally the equivalent of a transaction subject to a requirement that the disk be returned after such period. Similarly, a transaction in which the program deactivates itself after a specified period is generally the equivalent of returning the copy.

(g) *Rules of operation—(1) Term applied to transaction by parties.* Neither the form adopted by the parties to a transaction, nor the classification of the transaction under copyright law, shall be determinative. Therefore, for example, if there is a transfer of a computer program on a single disk for a one-time payment with restrictions on transfer and reverse engineering, which the parties characterize as a license (including, but not limited to, agreements commonly referred to as shrink-wrap licenses), application of the rules of paragraphs (c) and (f) of this section may nevertheless result in the transaction being classified as the sale of a copyrighted article.

(2) *Means of transfer not to be taken into account.* The rules of this section shall be applied irrespective of the physical or electronic or other medium used to effectuate a transfer of a computer program.

(3) *To the public—(i) In general.* For purposes of paragraph (c)(2)(i) of this section, a transferee of a computer program shall not be considered to have the right to distribute copies of the program to the public if it is permitted to distribute copies of the software to only either a related person, or to identified persons who may be identified by either name or by legal relationship to the original transferee. For purposes of this subparagraph, a related person is a person who bears a relationship to the transferee specified in section 267(b)(3), (10), (11), or (12), or section 707(b)(1)(B). In applying section 267(b), 267(f), 707(b)(1)(B), or 1563(a), “10 percent” shall be substituted for “50 percent.”

(ii) *Use by individuals.* The number of employees of a transferee of a computer program who are permitted to use the program in connection with their employment is not relevant for purposes of this paragraph (g)(3). In addition, the number of individuals with a contractual agreement to provide services to the transferee of a computer program who are permitted to use the program in connection with the performance of those services is not relevant for purposes of this paragraph (g)(3).

(h) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. (i) *Facts.* Corp A, a U.S. corporation, owns the copyright in a computer program, Program X. It copies Program X onto disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a shrink-wrap license. The license is stated to be perpetual. Under the license no reverse engineering, decompilation, or disassembly of the computer program is permitted. The transferee receives, first, the right to use the program on two of its own computers (for example, a laptop and a desktop) provided that only one copy is in use at any one time, and, second, the right to make one copy of the program on each machine as an essential step in the utilization of the program. The transferee is permitted by the shrink-wrap license to sell the copy so long as it destroys any other copies it has made and imposes the same terms and conditions of the license on the purchaser of its copy. These disks are made available for sale to the general public in Country Z. In return for valuable consideration, P, a Country Z resident, receives one such disk.

(ii) *Analysis.* (A) Under paragraph (g)(1) of this section, the label license is not determinative. None of the copyright rights described in paragraph (c)(2) of this section have been transferred in this transaction. P has received a copy of the program, however, and, therefore, under paragraph (c)(1)(ii) of this section, P has acquired solely a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 2. (i) *Facts.* The facts are the same as those in *Example 1*, except that instead of selling disks, Corp A, the U.S. corporation, decides to make Program X available, for a fee, on a World Wide Web home page on the Internet. P, the Country Z resident, in return for payment made to Corp A, downloads Program X (via modem) onto the hard drive of his computer. As part of the electronic communication, P signifies his assent to a license agreement with terms identical to those in *Example 1*, except that in this case P may make a back-up copy of the program on to a disk.

(ii) *Analysis.* (A) None of the copyright rights described in paragraph (c)(2) of this section have passed to P. Although P did not buy a physical copy of the disk with the program on it, paragraph (g)(2) of this section provides that the means of transferring the program is irrelevant. Therefore, P has acquired a copyrighted article.

(B) As in *Example 1*, P is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a sale of a copyrighted article rather than the grant of a lease.

Example 3. (i) *Facts.* The facts are the same as those in *Example 1*, except that Corp A only allows P, the Country Z resident, to use Program X for one week. At the end of that week, P must return the disk with Program X on it to Corp A. P must also destroy any copies made of Program X. If P wishes to use Program X for a further period he must enter into a new agreement to use the program for an additional charge.

(ii) *Analysis.* (A) Under paragraph (c)(2) of this section, P has received no copyright rights. Because P has received a copy of the program under paragraph (c)(1)(ii) of this section, he has, therefore, received a copyrighted article.

(B) Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. Taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result would be the same if P

were required to destroy the disk at the end of the one week period instead of returning it since Corp A can make additional copies of the program at minimal cost.

Example 4. (i) *Facts.* The facts are the same as those in *Example 2*, where P, the Country Z resident, receives Program X from Corp A's home page on the Internet, except that P may only use Program X for a period of one week at the end of which an electronic lock is activated and the program can no longer be accessed. Thereafter, if P wishes to use Program X, it must return to the home page and pay Corp A to send an electronic key to reactivate the program for another week.

(ii) *Analysis.* (A) As in *Example 3*, under paragraph (c)(2) of this section, P has not received any copyright rights. P has received a copy of the program, and under paragraph (g)(2) of this section, the means of transmission is irrelevant. P has, therefore, under paragraph (c)(1)(ii) of this section, received a copyrighted article.

(B) As in *Example 3*, P is not properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been a lease of a copyrighted article rather than a sale. While P does retain Program X on its computer at the end of the one week period, as a legal matter P no longer has the right to use the program (without further payment) and, indeed, cannot use the program without the electronic key. Functionally, Program X is no longer on the hard drive of P's computer. Instead, the hard drive contains only a series of numbers which no longer perform the function of Program X. Although in *Example 3*, P was required to physically return the disk, taking into account the special characteristics of computer programs as provided in paragraph (f)(3) of this section, the result in this *Example 4* is the same as in *Example 3*.

Example 5. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B an exclusive license for the remaining term of the copyright to copy and distribute an unlimited number of copies of Program X in the geographic area of Country Z, prepare derivative works based upon Program X, make public performances of Program X, and publicly display Program X. Corp B will pay Corp A a royalty of \$y a year for three years, which is the expected period during which Program X will have commercially exploitable value.

(ii) *Analysis.* (A) Although Corp A has transferred a disk with a copy of Program X on it to Corp B, under paragraph (c)(1)(i) of this section because this transfer is accompanied by a copyright right identified in paragraph (c)(2)(i) of this section, this transaction is a transfer solely of copyright rights, not of copyrighted articles. For purposes of paragraph (b)(2) of this section, the

disk containing a copy of Program X is a de minimis component of the transaction.

(B) Applying the all substantial rights test under paragraph (f)(1) of this section, Corp A will be treated as having sold copyright rights to Corp B. Corp B has acquired all of the copyright rights in Program X, has received the right to use them exclusively within Country Z, and has received the rights for the remaining life of the copyright in Program X. The fact the payments cease before the copyright term expires is not controlling. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty). (The result in this case would be the same if the copy of Program X to be used for the purposes of reproduction were transmitted electronically to Corp B, as a result of the application of the rule of paragraph (g)(2) of this section.)

Example 6. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp B, a Country Z corporation, and grants Corp B the non exclusive right to reproduce (either directly or by contracting with either Corp A or another person to do so) and distribute for sale to the public an unlimited number of disks at its factory in Country Z in return for a payment related to the number of disks copied and sold. The term of the agreement is two years, which is less than the remaining life of the copyright.

(ii) *Analysis.* (A) As in *Example 5*, the transfer of the disk containing the copy of the program does not constitute the transfer of a copyrighted article under paragraph (c)(1) of this section because Corp B has also acquired a copyright right under paragraph (c)(2)(i) of this section, the right to reproduce and distribute to the public. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction.

(B) Taking into account all of the facts and circumstances, there has been a license of Program X to Corp B, and the payments made by Corp B are royalties. Under paragraph (f)(1) of this section, there has not been a transfer of all substantial rights in the copyright to Program X because Corp A has the right to enter into other licenses with respect to the copyright of Program X, including licenses in Country Z (or even to sell that copyright, subject to Corp B's interest). Corp B has acquired no right itself to license the copyright rights in Program X. Finally, the term of the license is for less than the remaining life of the copyright in Program X.

Example 7. (i) *Facts.* Corp C, a distributor in Country Z, enters into an agreement with Corp A, a U.S. corporation, to purchase as many copies of Program X on disk as it may from time-to-time request. Corp C will then sell these disks to retailers. The disks are

shipped in boxes covered by shrink-wrap licenses (identical to the license described in *Example 1*).

(ii) *Analysis.* (A) Corp C has not acquired any copyright rights under paragraph (c)(2) of this section with respect to Program X. It has acquired individual copies of Program X, which it may sell to others. The use of the term license is not dispositive under paragraph (g)(1) of this section. Under paragraph (c)(1)(ii) of this section, Corp C has acquired copyrighted articles.

(B) Taking into account all of the facts and circumstances, Corp C is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles.

Example 8. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the non-exclusive right to copy Program X onto the hard drive of an unlimited number of computers, which Corp D manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads on to computers.

(ii) *Analysis.* The analysis is the same as in *Example 6*. Under paragraph (c)(2)(i) of this section, Corp D has acquired a copyright right enabling it to exploit Program X by copying it on to the hard drives of the computers that it manufactures and then sells. For purposes of paragraph (b)(2) of this section, the disk containing Program X is a de minimis component of the transaction. Taking into account all of the facts and circumstances, Corp D has not, however, acquired all substantial rights in the copyright to Program X (for example, the term of the agreement is less than the remaining life of the copyright). Under paragraph (f)(1) of this section, this transaction is, therefore, a license of Program X to Corp D rather than a sale and the payments made by Corp D are royalties. (The result would be the same if Corp D included with the computers it sells an archival copy of Program X on a floppy disk.)

Example 9. (i) *Facts.* The facts are the same as in *Example 8*, except that Corp D, the Country Z corporation, receives physical disks. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the licenses described in *Example 1*). The terms of these licenses do not permit Corp D to make additional copies of Program X. Corp D uses each individual disk only once to load a single copy of Program X onto each separate computer. Corp D transfers the disk with the computer when it is sold.

(ii) *Analysis.* (A) As in *Example 7* (unlike *Example 8*) no copyright right identified in paragraph (c)(2) of this section has been transferred. Corp D acquires the disks without the right to reproduce and distribute publicly further copies of Program X. This is therefore the transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all of the facts and circumstances, Corp D is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, the transaction is classified as the sale of a copyrighted article. (The result would be the same if Corp D used a single physical disk to copy Program X onto each computer, and transferred an unopened box containing Program X with each computer, if Corp D were not permitted to copy Program X onto more computers than the number of individual copies purchased.)

Example 10. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a Country Z corporation, and grants Corp E the right to load Program X onto 50 individual workstations for use only by Corp E employees at one location in return for a one-time per-user fee (generally referred to as a site license or enterprise license). If additional workstations are subsequently introduced, Program X may be loaded onto those machines for additional one-time per-user fees. The license which grants the rights to operate Program X on 50 workstations also prohibits Corp E from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the license is stated to be perpetual.

(ii) *Analysis.* (A) The grant of a right to copy, unaccompanied by the right to distribute those copies to the public, is not the transfer of a copyright right under paragraph (c)(2) of this section. Therefore, under paragraph (c)(1)(ii) of this section, this transaction is a transfer of copyrighted articles (50 copies of Program X).

(B) Taking into account all of the facts and circumstances, P is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been a sale of copyrighted articles rather than the grant of a lease. Notwithstanding the restriction on sale, other factors such as, for example, the risk of loss and the right to use the copies in perpetuity outweigh, in this case, the restrictions placed on the right of alienation.

(C) The result would be the same if Corp E were permitted to copy Program X onto an unlimited number of workstations used by employees of either Corp E or corporations that had a relationship to Corp E specified in paragraph (g)(3) of this section.

Example 11. (i) *Facts.* The facts are the same as in *Example 10*, except that Corp E, the Country Z corporation, acquires the right to make Program X available to

workstation users who are Corp E employees by way of a local area network (LAN). The number of users that can use Program X on the LAN at any one time is limited to 50. Corp E pays a one-time fee for the right to have up to 50 employees use the program at the same time.

(ii) *Analysis.* Under paragraph (g)(2) of this section the mode of utilization is irrelevant. Therefore, as in *Example 10*, under paragraph (c)(2) of this section, no copyright right has been transferred, and, thus, under paragraph (c)(1)(ii) of this section, this transaction will be classified as the transfer of a copyrighted article. Under the benefits and burdens test of paragraph (f)(2) of this section, this transaction is a sale of copyrighted articles. The result would be the same if an unlimited number of Corp E employees were permitted to use Program X on the LAN or if Corp E were permitted to copy Program X onto LANs maintained by corporations that had a relationship to Corp E specified in paragraph (g)(3) of this section.

Example 12. (i) *Facts.* The facts are the same as in *Example 11*, except that Corp E pays a monthly fee to Corp A, the U.S. corporation, calculated with reference to the permitted maximum number of users (which can be changed) and the computing power of Corp E's server. In return for this monthly fee, Corp E receives the right to receive upgrades of Program X when they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, Corp E must return the disk containing the earlier version of Program X to Corp A. If the contract is terminated, Corp E must delete (or otherwise destroy) all copies made of the current version of Program X. The agreement also requires Corp A to provide technical support to Corp E but the agreement does not allocate the monthly fee between the right to receive upgrades of Program X and the technical support services. The amount of technical support that Corp A will provide to Corp E is not foreseeable at the time the contract is entered into but is expected to be de minimis. The agreement specifically provides that Corp E has not thereby been granted an option to purchase Program X.

(ii) *Analysis.* (A) Corp E has received no copyright rights under paragraph (c)(2) of this section. Corp A has not provided any services described in paragraph (d) of this section. Based on all the facts and circumstances of the transaction, Corp A has provided de minimis technical services to Corp E. Therefore, under paragraph (c)(1)(ii) of this section, the transaction is a transfer of a copyrighted article.

(B) Taking into account all facts and circumstances, under the benefits and burdens test Corp E is not properly treated as the owner of the copyrighted article. Corp E does

not receive the right to use Program X in perpetuity, but only for so long as it continues to make payments. Corp E does not have the right to purchase Program X on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Corp A or a certain period of time has elapsed (which might indicate a sale). Once the agreement is terminated, Corp E will no longer possess any copies of Program X, current or superseded. Therefore under paragraph (f)(2) of this section there has been a lease of a copyrighted article.

Example 13. (i) *Facts.* The facts are the same as in *Example 12*, except that, while Corp E must return copies of Program X as new upgrades are received, if the agreement terminates, Corp E may keep the latest version of Program X (although Corp E is still prohibited from selling or otherwise transferring any copy of Program X).

(ii) *Analysis.* For the reasons stated in *Example 10*, paragraph (ii)(B), the transfer of the program will be treated as a sale of a copyrighted article rather than as a lease.

Example 14. (i) *Facts.* Corp G, a Country Z corporation, enters into a contract with Corp A, a U.S. corporation, for Corp A to modify Program X so that it can be used at Corp G's facility in Country Z. Under the contract, Corp G is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Corp A to rewrite elements of Program X so that it will conform to Country Z accounting standards and states that Corp A retains all copyright rights in the modified Program X. The agreement between Corp A and Corp G is otherwise identical as to rights and payment terms as the agreement described in *Example 10*.

(ii) *Analysis.* (A) As in *Example 10*, no copyright rights are being transferred under paragraph (c)(2) of this section. In addition, since no copyright rights are being transferred to Corp G, this transaction does not involve the provision of services by Corp A under paragraph (d) of this section. This transaction will be classified, therefore, as a transfer of copyrighted articles under paragraph (c)(1)(ii) of this section.

(B) Taking into account all facts and circumstances, Corp G is properly treated as the owner of copyrighted articles. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 15. (i) *Facts.* Corp H, a Country Z corporation, enters into a license agreement for a new computer program. Program Q is to be written by Corp A, a U.S. corporation. Corp A and Corp H agree that Corp A is writing Program Q for Corp H and that, when Program Q is completed, the copyright in Program Q will belong to Corp H. Corp H gives instructions to Corp A programmers regarding program specifications. Corp H

agrees to pay Corp A a fixed monthly sum during development of the program. If Corp H is dissatisfied with the development of the program, it may cancel the contract at the end of any month. In the event of termination, Corp A will retain all payments, while any procedures, techniques or copyrightable interests will be the property of Corp H. All of the payments are labelled royalties. There is no provision in the agreement for any continuing relationship between Corp A and Corp H, such as the furnishing of updates of the program, after completion of the modification work.

(ii) *Analysis.* Taking into account all of the facts and circumstances, Corp A is treated as providing services to Corp H. Under paragraph (d) of this section, Corp A is treated as providing services to Corp H because Corp H bears all of the risks of loss associated with the development of Program Q and is the owner of all copyright rights in Program Q. Under paragraph (g)(1) of this section, the fact that the agreement is labelled a license is not controlling (nor is the fact that Corp A receives a sum labelled a royalty).

Example 16. (i) *Facts.* Corp A, a U.S. corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp I to more efficiently create computer programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects, and are furnished to Corp I under nondisclosure conditions. Such information is property subject to trade secret protection.

(ii) *Analysis.* This transaction contains the elements of know-how specified in paragraph (e) of this section. Therefore, this transaction will be treated as the provision of know-how.

Example 17. (i) *Facts.* Corp A, a U.S. corporation, transfers a disk containing Program Y to Corp E, a Country Z corporation, in exchange for a single fixed payment. Program Y is a computer program development program, which is used to create other computer programs, consisting of several components, including libraries of reusable software components that serve as general building blocks in new software applications. No element of these libraries is a significant component of any overall new program. Because a computer program created with the use of Program Y will not operate unless the libraries are also present, the license agreement between Corp A and Corp E grants Corp E the right to distribute copies of the libraries with any program developed using Program Y. The license agreement is otherwise identical to the license agreement in *Example 1*.

(ii) *Analysis.* (A) No non-de minimis copyright rights described in paragraph (c)(2) of this section have passed to Corp E. For purposes of paragraph (b)(2) of this section, the right to distribute the libraries in conjunction with the programs created using Program Y is a de minimis component of the transaction. Because Corp E has received a copy of the program under paragraph (c)(1)(ii) of this section, it has received a copyrighted article.

(B) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

Example 18. (i) *Facts.* (A) Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a country Z Corporation. The disk contains both the object code and the source code to Program X and the license agreement grants Corp E the right to—

(1) Modify the source code in order to correct minor errors and make minor adaptations to Program X so it will function on Corp E's computer; and

(2) Recompile the modified source code.

(B) The license does not grant Corp E the right to distribute the modified Program X to the public. The license is otherwise identical to the license agreement in *Example 1*.

(ii) *Analysis.* (A) No non-de minimis copyright rights described in paragraph (c)(2) of this section have passed to Corp E. For purposes of paragraph (b)(2) of this section, the right to modify the source code and recompile the source code in order to create new code to correct minor errors and make minor adaptations is a de minimis component of the transaction. Because Corp E has received a copy of the program under paragraph (c)(1)(ii) of this section, it has received a copyrighted article.

(B) Taking into account all the facts and circumstances, Corp E is properly treated as the owner of a copyrighted article. Therefore, under paragraph (f)(2) of this section, there has been the sale of a copyrighted article rather than the grant of a lease.

(i) *Effective date*—(1) *General.* This section applies to transactions occurring pursuant to contracts entered into on or after December 1, 1998.

(2) *Elective transition rules*—(i) *Contracts entered into in taxable years ending on or after October 2, 1998.* A taxpayer may elect to apply this section to transactions occurring pursuant to contracts entered into in taxable years ending on or after October 2, 1998. A taxpayer that makes an election under this paragraph (i)(2)(i) must apply this section to all contracts entered into in

taxable years ending on or after October 2, 1998.

(ii) *Contracts entered into before October 2, 1998.* A taxpayer may elect to apply this section to transactions occurring in taxable years ending on or after October 2, 1998 pursuant to contracts entered into before October 2, 1998 provided the taxpayer would not be required under this section to change its method of accounting as a result of such election, or the taxpayer would be required to change its method of accounting but the resulting section 481(a) adjustment would be zero. A taxpayer that makes an election under this paragraph (i)(2)(ii) must apply this section to all transactions occurring in taxable years ending on or after October 2, 1998 pursuant to contracts entered into before October 2, 1998.

(3) *Manner of making election.* Taxpayers may elect, under paragraph (i)(2)(i) or (i)(2)(ii) of this section, to apply this section, by treating the transactions in accordance with these regulations on their original tax return.

(4) *Examples.* The following examples illustrate application of the transition rule of paragraph (i)(2)(ii) of this section:

(i) *Example 1.* Corp A develops computer programs for sale to third parties. Corp A uses an overall accrual method of accounting and files its tax return on a calendar-year basis. In year 1, Corp A enters into a contract to deliver a computer program in that year, and to provide updates for each of the following four years. Under the contract, the computer program and the updates are priced separately, and Corp A is entitled to receive payments for the computer program and each of the updates upon delivery. Assume Corp A properly accounts for the contract as a contract for the provision of services. Corp A properly includes the payments under the contract in gross income in the taxable year the payments are received and the computer program or updates are delivered. Corp A properly deducts the cost of developing the computer program and updates when the costs are incurred. Year 3 includes October 2, 1998. Assume under the rules of this section, the provision of updates would properly be accounted for as the